economic trends

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Alberta's economy enters 2014 firing on all cylinders

This edition of Trends is taken from the Third Quarter Fiscal Update and Economic Statement, released on February 26, 2014. The inFocus examines what a weaker loonie means for the Alberta economy.

The Alberta economy gained momentum through 2013 and is off to a strong start this year. Growth is widespread, with many indicators gathering strength in the second half of last year.

In the household sector, the province saw solid job growth throughout 2013 even as the national job market slowed. New housing activity strengthened in 2013, and into this year, as migrants continued to enter the market. Record net migration in 2013 has not only helped fuel consumption and housing, it has also provided Alberta with a source of labour during its expansion. In the business sector, output has also accelerated following a weak start to 2013.

Overall, the Alberta economy grew by an estimated 3.3% in 2013. This is slightly higher than the expected 2.9% increase at *Budget 2013*, reflecting flood reconstruction activity and stronger-than-forecast population growth. In 2014, real GDP growth is expected to accelerate to 3.7%, lifted by exports, residential and business investment, as well as flood-related spending.

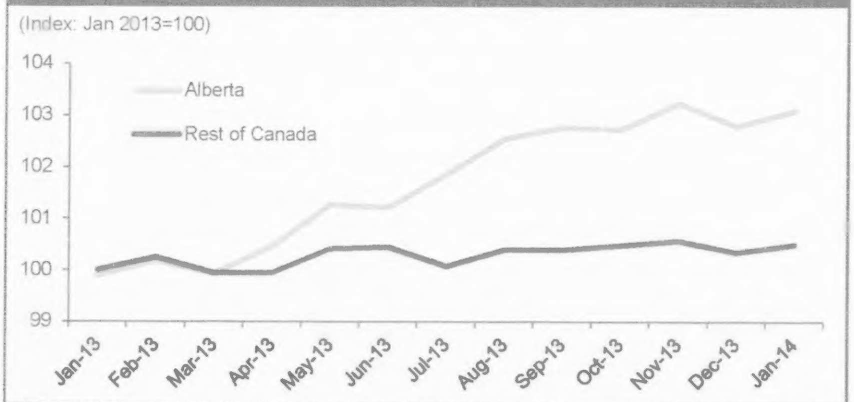
Alberta Household Sector

Labour market spurs migration

Alberta households were a major driver of economic activity in 2013. Retail sales rose by an estimated 6.7% for the second straight year, led by motor vehicle sales.

Alberta's robust labour market continues to underpin gains in the household sector. Strong job growth persisted through most of 2013 and into 2014, even as gains in the rest of Canada slowed to a crawl (Figure 1). Alberta added an average of 5,700 jobs per month in 2013 compared with only 2,600 in all other provinces. Alberta holds more than a fifth of all job vacancies in Canada, pointing to further job growth ahead. With momentum heading into 2014, strong employment growth of 2.6% is expected this year. Not surprisingly, the labour market has attracted record inflows of migrants. Alberta's population surged past four million in 2013, growing by the highest rate since 1981 at 3.5%. In 2014, population growth is forecast to moderate, but remain solid at 2.9%.

Figure 1. Employment Growth



Source: Statistics Canada

Housing market tightens

Alberta's housing market has been buoyed by a persistent influx of migrants. The resale market is now firmly in sellers' territory, while the number of completed but unabsorbed units in Calgary and Edmonton has fallen close to a 6-year low (Figure 2). The tightening of the market has pushed rents higher, and led to some modest pressure on housing prices. The ongoing transition of new migrants from rental to owned accommodation is expected to support further gains in housing activity in the province. Housing starts are forecast to increase to 38,300 in 2014.

Strong but steady wage growth

In-migration has lifted labour supply and kept wage growth contained. Recent growth in average weekly earnings has been around 3.5%, below the ten-year average. Based on a stronger outlook for employment and population, the forecast for 2014 household income growth has been upgraded since *Budget 2013*.

Consumer prices rose at an average rate of 1.4% in 2013, the second straight year below 2% and well below growth in wages. Strong in-migration, coupled with slack in the global economy, has contributed to low price inflation and allowed Alberta to grow quickly without triggering major inflation pressures. Inflation is expected to pick-up slightly in 2014 to 2.2%, due to stronger shelter costs and a weaker Canadian dollar.

Alberta Business Sector

Output accelerates through 2013

Exports jumped in the second half after being slowed by maintenance outages at refineries and delays at oil sands facilities earlier in the year (Figure 3). The rebound

in production coincided with higher prices for oil produced in Alberta relative to the previous year. Manufactured product sales also reversed a weak start in 2013. In the agriculture sector, farmers witnessed a bumper crop in 2013, as favourable weather conditions pushed wheat and canola production to record heights.

Crude by rail surges

Moving crude oil products by rail took off in 2013 amid ongoing constraints in the pipeline network. With new onloading facilities being developed, further increases in crude shipments by rail are expected.

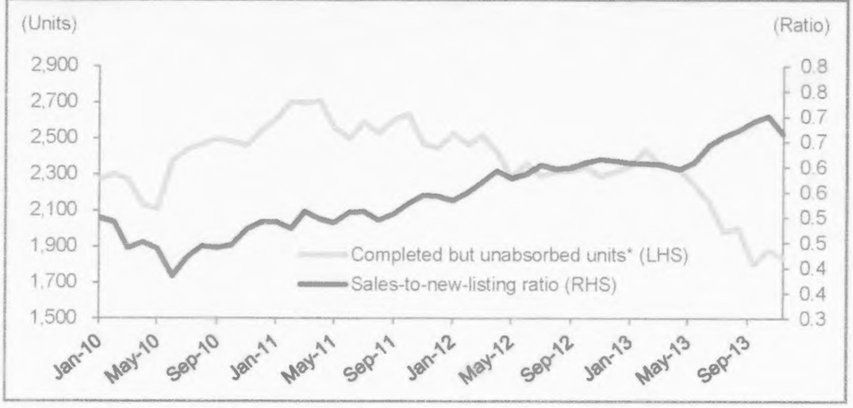
Building activity trends higher

Alberta's fast growing economy and population, along with flood recovery efforts, supported the construction sector in 2013. Non-residential building construction investment rose 3.4%, due to gains in the industrial and institutional/government sectors. Building permits continue to trend higher, pointing to further construction gains ahead. Despite strong activity, construction cost increases have remained below historic norms in Calgary and Edmonton.

Dollar hits 4 1/2 year low

The Canadian dollar has dropped sharply against the US dollar, averaging 90 US¢/C$ in recent weeks (see page 13-14). Based on recent developments, the exchange rate forecast for 2013-14 has been lowered to 95.1 US¢/C$.

Figure 2. Alberta Resale and New Housing Indicators



Sources: CMHC and CREA
* Includes Edmonton and Calgary only

Oil price outlook largely unchanged

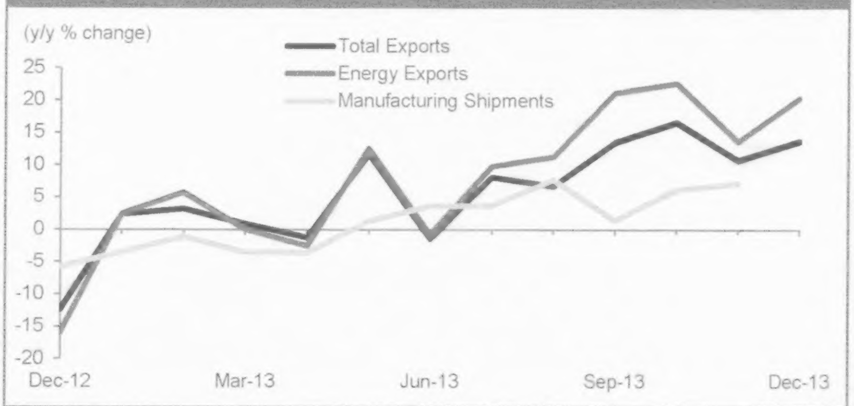
The oil price outlook for 2013-14 remains up from *Budget 2013*, but roughly in line with Second Quarter. Oil price differentials remain highly volatile due to lack of spare capacity in the pipeline network. Natural gas prices have risen in recent months due to abnormally cold weather in North America. However, due to weaker prices through most of 2013, the ARP forecast for 2013-14 is roughly unchanged from *Budget 2013*.

External Risks

Global economic growth is picking up, led by improvements in advanced economies. However, as a commodity and trade driven economy, Alberta is subject to a number of risks:

- With a shortage of pipeline capacity, the price of Alberta oil is volatile and highly susceptible to transportation and refinery disruptions.
- Unwinding the Federal Reserve's unprecedented quantitative easing program could cause further volatility in financial markets and weigh on emerging market economies. A further slowdown in emerging markets would hurt global demand and commodity prices.
- The US economy is gaining momentum, and remains an upside risk to the forecast.
- Faster-than-expected global growth could put upward pressure on oil prices, boosting Alberta investment and employment.

Figure 3. Alberta Exports and Manufacturing Shipments



Sources: Statistics Canada

What does a weaker loonie mean for Alberta?

One of the most noteworthy financial developments in recent months has been the decline of the Canadian dollar. While the dollar has been trending downward for well over a year, the depreciation has accelerated since early 2014. The loonie hit a 4.5 year low against the US dollar in late January at 89 US¢/Cdn$ and has been trading around 90 US¢/Cdn$ in recent weeks (Figure 1). The contributing factors to this decline and the impact of a lower loonie on Alberta are discussed below.

Canadian dollar loses some of its appeal

In the years following the recession, Canada was an appealing investment destination given its historically stable financial system and relatively low federal debt levels. These factors kept demand for Canadian securities high and the loonie elevated near parity despite weak export performance and large trade deficits. Another factor was the prospect of higher returns, as the Bank of Canada suggested it may raise interest rates to help curb rising levels of household debt.

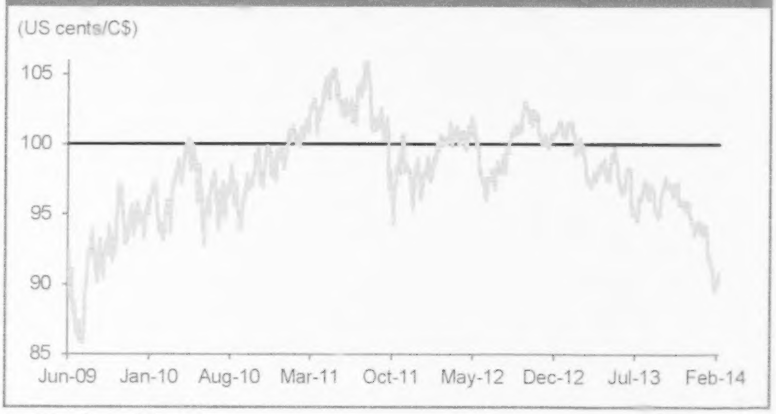
Over the course of 2013 many of the factors that were lending strength to the dollar receded. Risk globally was reduced as Europe made tentative steps towards recovery and US lawmakers compromised on a budget, reducing fiscal uncertainty. While this is undoubtedly positive for the global economy, it also gives foreign investors less incentive to seek the safety of Canadian assets at a time when they were already becoming more risk tolerant. These factors have contributed to a drop off in net portfolio inflows into Canada (Figure 2).

Financial inflows have also suffered from lower expected returns as the Bank of Canada has communicated to markets that it expects interest rates to remain low for longer than it previously anticipated. This reflects a shift in concern away from household debt and towards below target inflation. As a result of weak demand, inflation in Canada has been persistently low and repeatedly come in below the Bank's forecast. The Bank has emphasized that a lower Canadian dollar could improve Canada's export performance, suggesting that it is comfortable with a lower exchange rate.

Two sides to the story

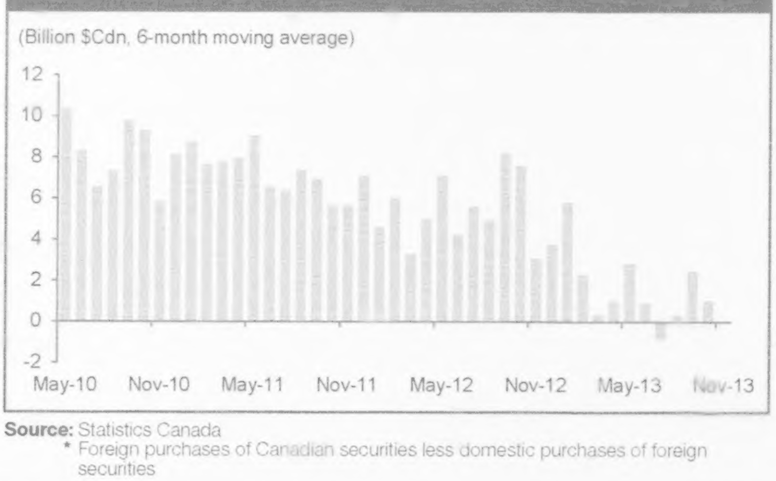
Canada is only one side of the story. A stronger US dollar has also contributed to some of the depreciation. The outlook for the US economy has improved, lending strength to the US dollar. A brighter outlook also allows the Federal Reserve to pare back stimulus, which adds further support by increasing US interest rates. Due

Figure 1. US - Canada Exchange Rate



Source: Bank of Canada

Figure 2. Net Purchases of Canadian Securities*



Source: Statistics Canada
* Foreign purchases of Canadian securities less domestic purchases of foreign securities

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to US dollar strength, the loonie has fallen further against the US dollar than it has against the next ten most traded currencies on average (Figure 3). Based on this basket of currencies, slightly more than a quarter of the depreciation since the start of 2013 has been due to US dollar strengthening.

The impact on Alberta's economy

A depreciation of the Canadian dollar benefits Alberta primarily through exports. Exporters with prices denominated in US dollars receive a higher Canadian dollar price after a depreciation, which leads to higher revenues. Exporters with prices denominated in Canadian dollars become more competitive following a depreciation as their goods become less expensive for their US customers. Albertans who hold US assets will benefit as the Canadian dollar value of these assets increases following a depreciation.

On the other hand, import prices increase with a lower dollar, which increases costs for consumers and businesses. Many consumer goods are imported so higher import prices eventually result in higher prices for consumers, though research suggests this adjustment occurs gradually over several years. Businesses will also face higher costs as imported parts and materials become more expensive as does investing in machinery and equipment.

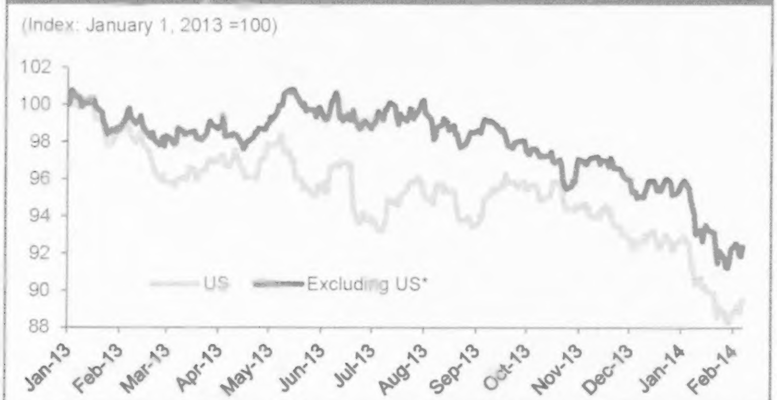
A boost to royalties

The Government of Alberta's royalty revenue is sensitive to changes in the exchange rate. Energy prices are determined in the global market and mainly priced in US dollars. When the Canadian dollar depreciates, producers earn more Canadian dollar revenue on the same energy prices. This increases the revenue base from which the province collects royalties.

Royalties can also increase due to changes in the royalty rate itself. The royalty rate that oil sands projects pay under the generic royalty regime is directly linked to the WTI price in Canadian dollars (Figure 4). All else being equal, a lower dollar increases the Canadian dollar price of oil, thereby increasing the royalty rate paid by oil sands producers. The higher producer revenue can also push oil sands projects into their "payout" period sooner, meaning producers have received enough revenue to cover their capital costs on a particular project. This is important as producers in the payout period are subject to a higher royalty rate on net revenue, which boosts future royalty revenues.

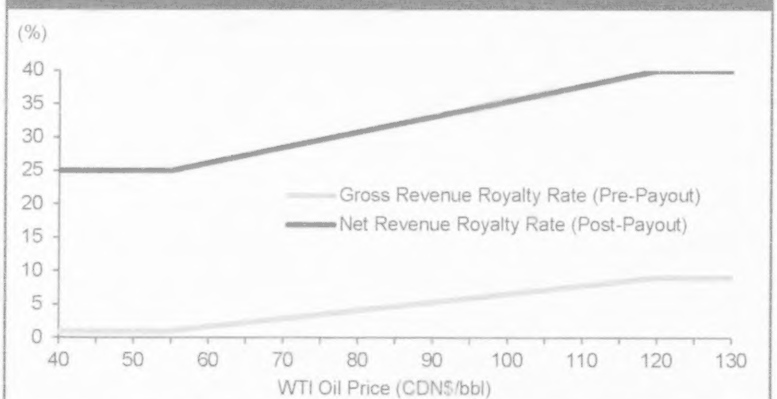
An offsetting factor is that a lower loonie can raise many direct costs that are deductible for royalty purposes. Imported equipment, for example, will cost more as the Canadian dollar depreciates. The net impact of a lower Canadian dollar is positive in terms of provincial royalty revenue. For small movements in the Canadian dollar, the estimated impact of a 1 US¢ decline is about $160 million in additional government revenue in 2013-14.

Figure 3. Canadian Dollar Against Different Currencies



Source: Haver Analytics.
* Basket of 10 most traded non-US currencies.

Figure 4. Alberta Royalty Rates for Oil Sands Projects



Source: Alberta Energy

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